Islamic Investment: Products, Opportunities, and Challenges

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Agenda

1. What is Islamic Investment?
2. Islamic Investment Products in the International Financial Market
3. Islamic Investment: Opportunities & Challenges
4. Islamic Investment & Equity Based Intermediation System

Islamic Investment is part of the Growing Islamic Banking & Finance Needs

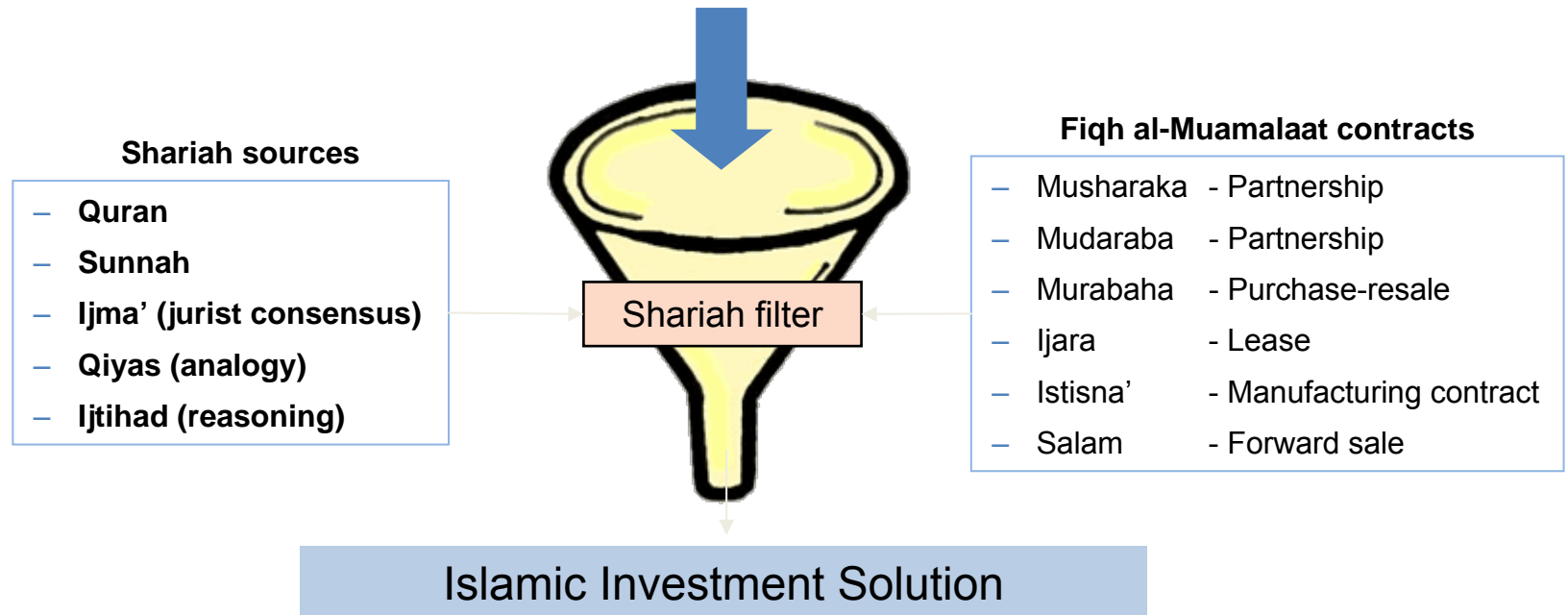
Banking and finance needs

Shariah sources

- **Quran**
- **Sunnah**
- **Ijma' (jurist consensus)**
- **Qiyas (analogy)**
- **Ijtihad (reasoning)**

Fiqh al-Muamalaat contracts

- Musharaka - Partnership
- Mudaraba - Partnership
- Murabaha - Purchase-resale
- Ijara - Lease
- Istisna' - Manufacturing contract
- Salam - Forward sale

Islamic Investment Solution

- Asset-backed transactions
- The Principle of "No Risk, No Reward"

- Prohibition of certain investments:
  - Sectors (e.g.: alcohol, armaments, financial services, gambling, pork, pornography, tobacco)
  - Instruments (e.g. no forward transactions, limited option use, no derivatives, short-selling)

- Type of Investments:
  - Through the Capital Market
  - Direct Investment (Islamic Private Equity Fund & Venture Capital)

- Islamic Investment: Toward Equity based Financial Intermediation

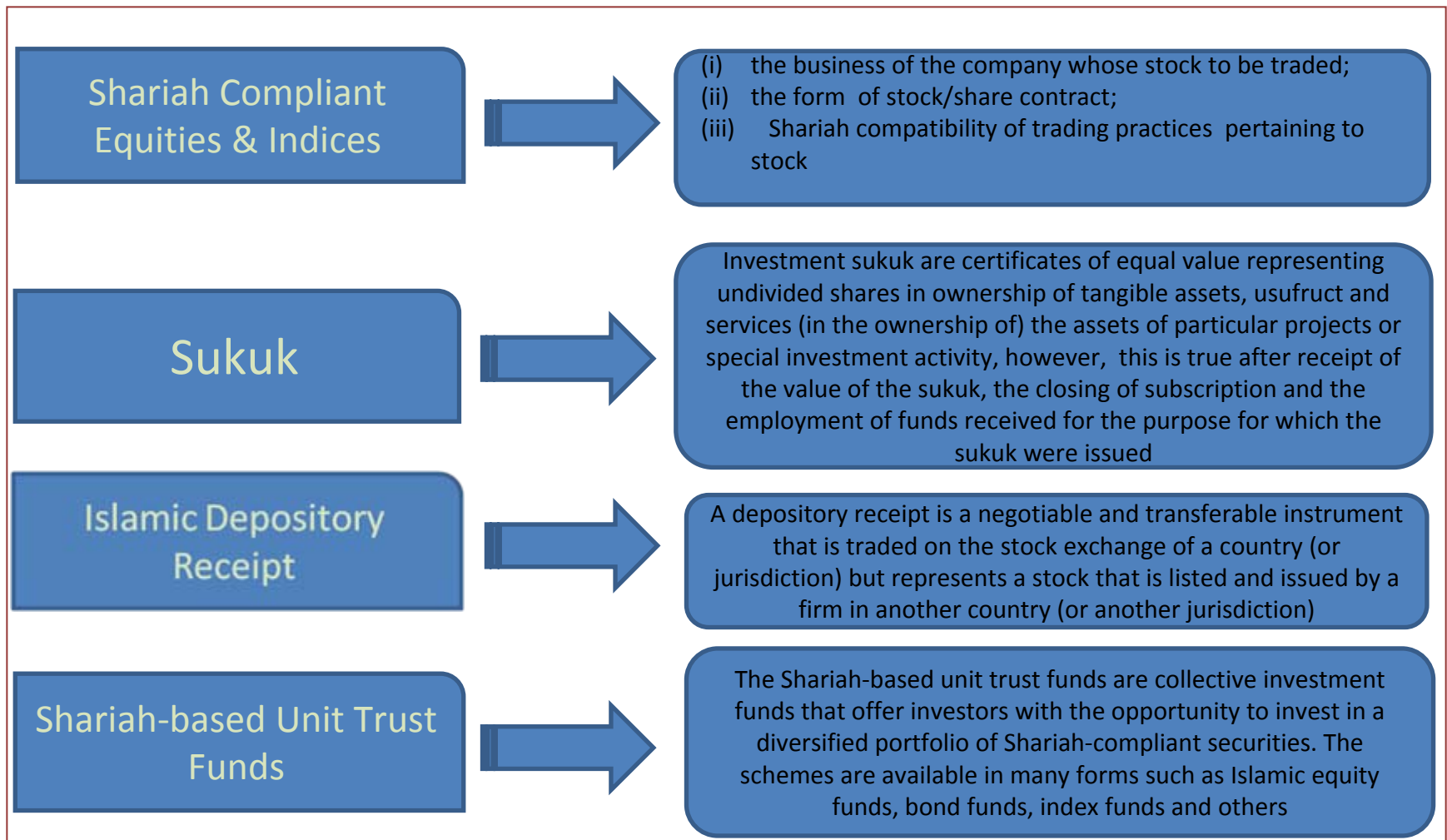
Bigger Picture: The Objective of *Shariah*

The very objective of the Shariah is to promote the welfare of the people, which lies in safeguarding their faith, their life, their intellect, their posterity and their wealth. Whatever ensures the safeguarding of these five serves public interest and is desirable.

Al-Ghazali

The basis of the Shariah is wisdom and welfare of the people in this world as well as the Hereafter. This welfare lies in complete justice, mercy, well-being and wisdom. Anything that departs from justice to oppression, from mercy to harshness, from welfare to misery and from wisdom to folly, has nothing to do with the *Shariah.*

Ibn al-Qayyim

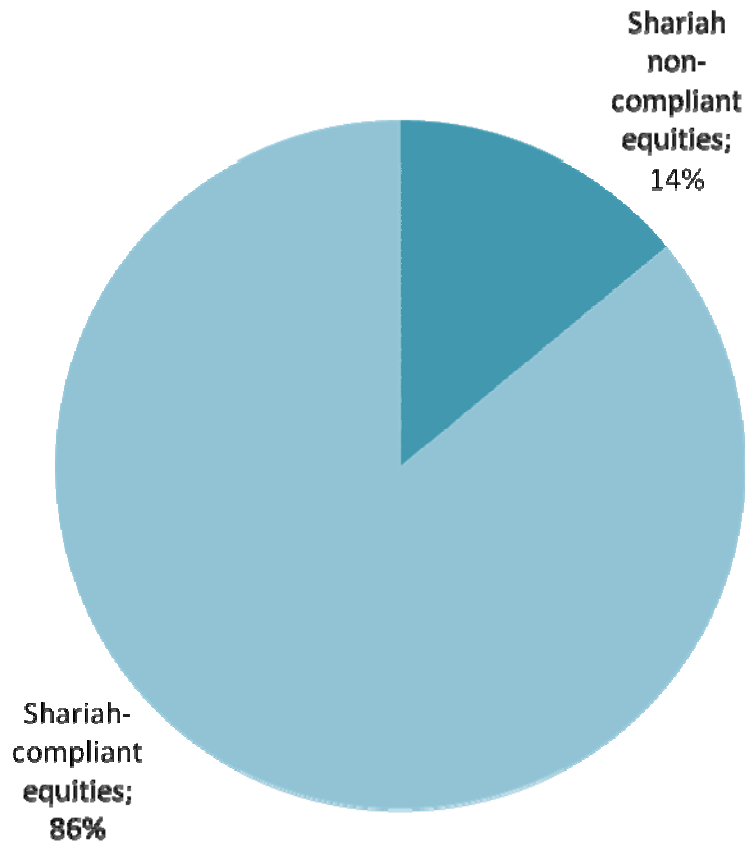
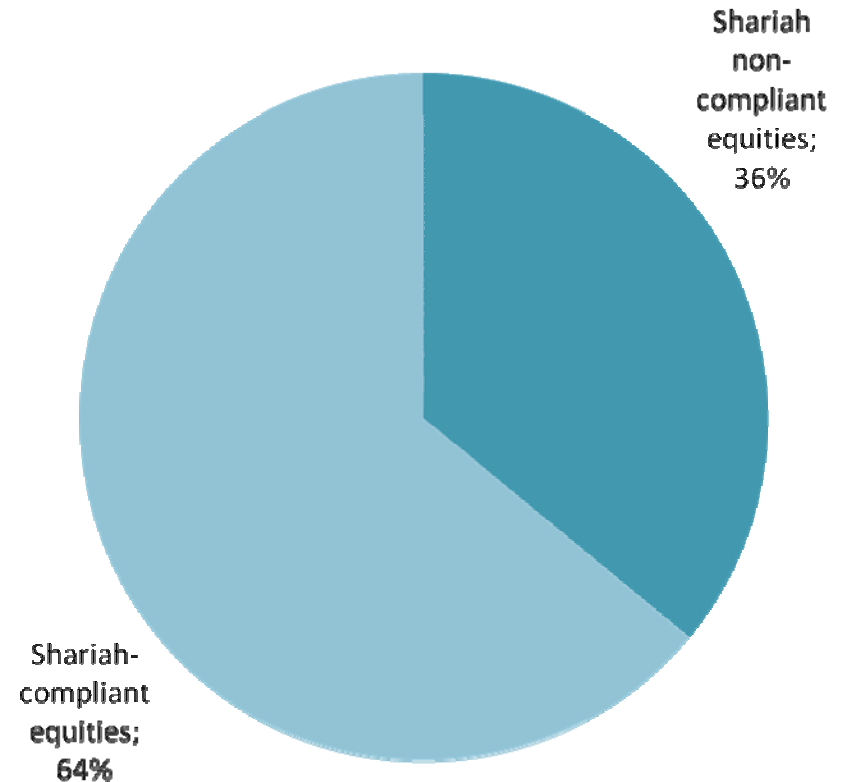
Islamic Capital Market Products

Financial Screening Ratios (Simplified)

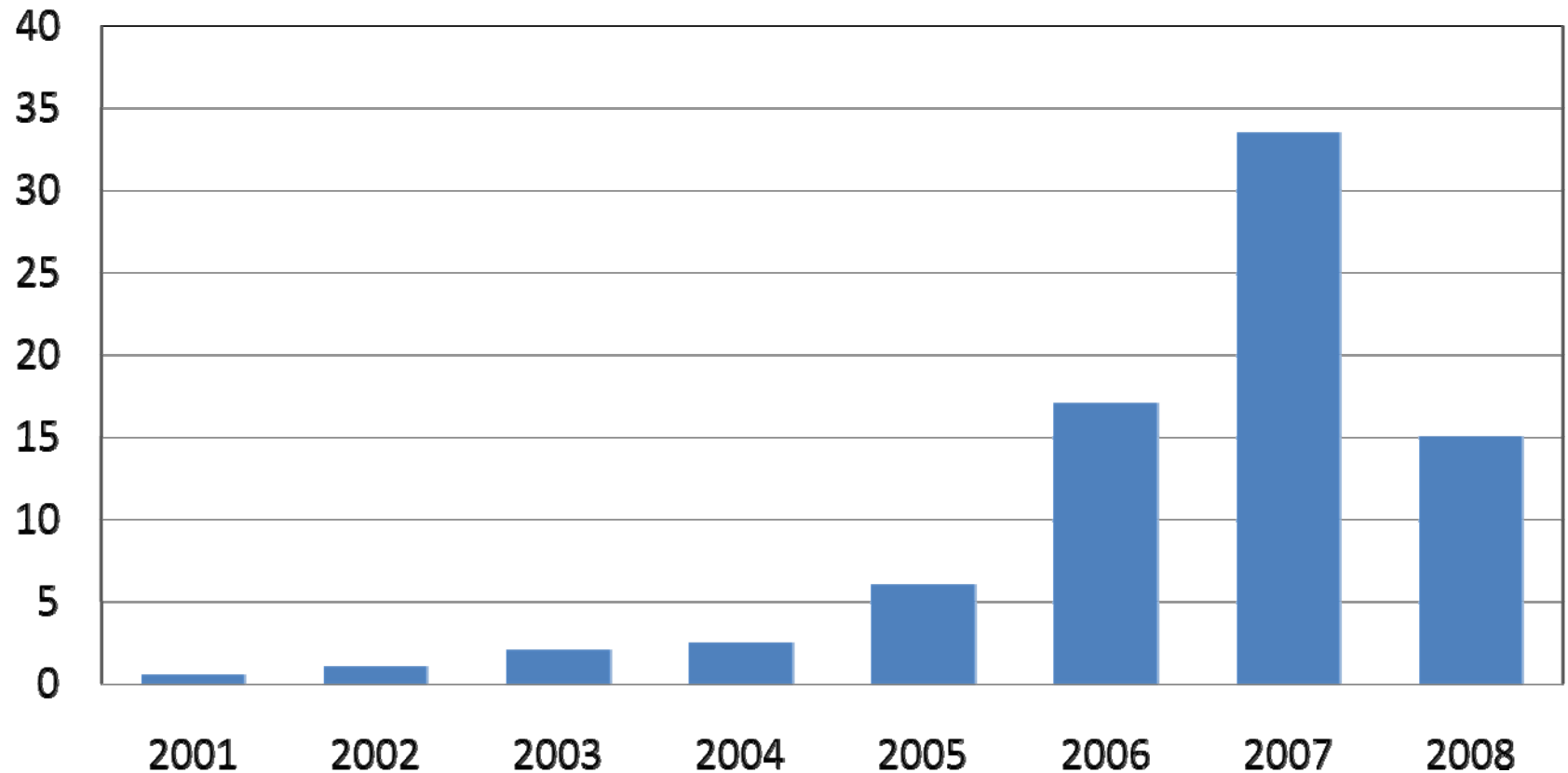
	Debt Ratio	Receivables Ratio	Cash + Interest-bearing ratio	Non-permissible income/total income
DJIM[1]	33%	33%	33%	≤5%
FTSE[2]	33%	50%	33%	≤5%
S&P[3]	33%	49%	33%	≤5%
MSCI[4]	33%	70%	33%	≤5%
Parsoli[5]	33%	45%	33%	≤10%
HK Islamic Index[6]	33%	49%	33%	≤5%

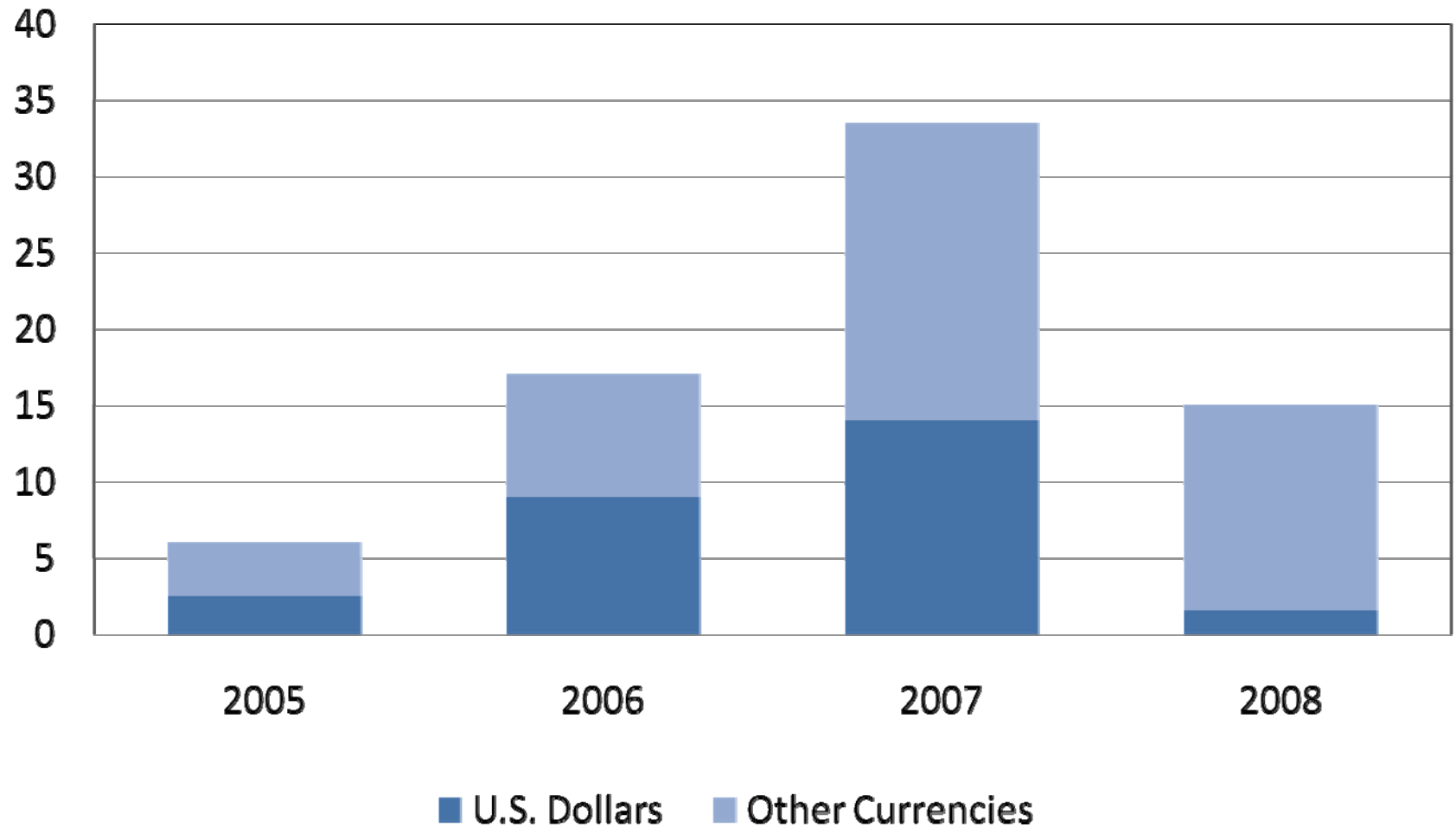
[1] Guide to DJIM Indexes November 2007
[2] Ground rules for the Management of FTSE Shariah Global Equity Index Series Version 1.2 March 2008
[3] S&P Shariah Indices Index Methodology, June 2007
[4] Morgan Stanley MSCI Islamix Index Series Methodology April 2007
[5] Parsoli Islamic Equity Index PIE
[6] Hong Kong Islamic Index

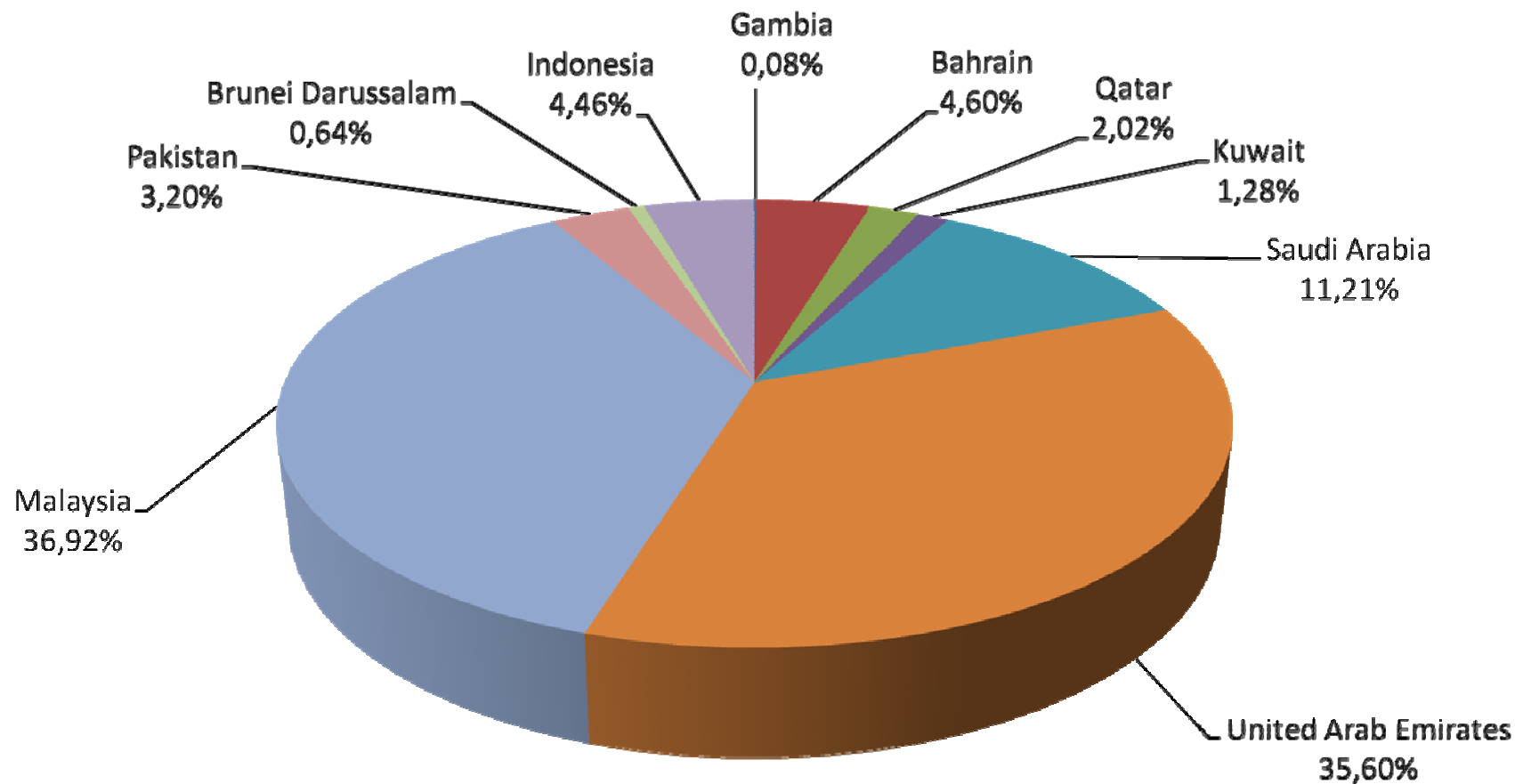
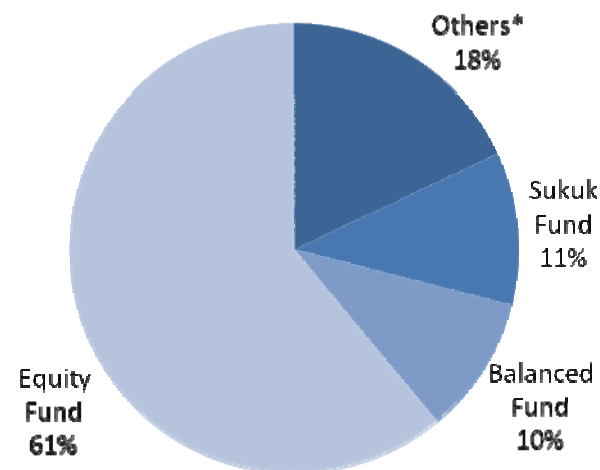
Source: Islamic Finance news

Sharia Compliant Securities Listed on KLSE

Source: Securities Commission Malaysia, 2007

Total Sukuk Issuance (2001-2008)

Source: Standard & Poor's, 2009

Total Sukuk Issuance (2005-2008)

Source: Standard & Poor's, 2009

Global Sukuk Issuance by Country in 2008

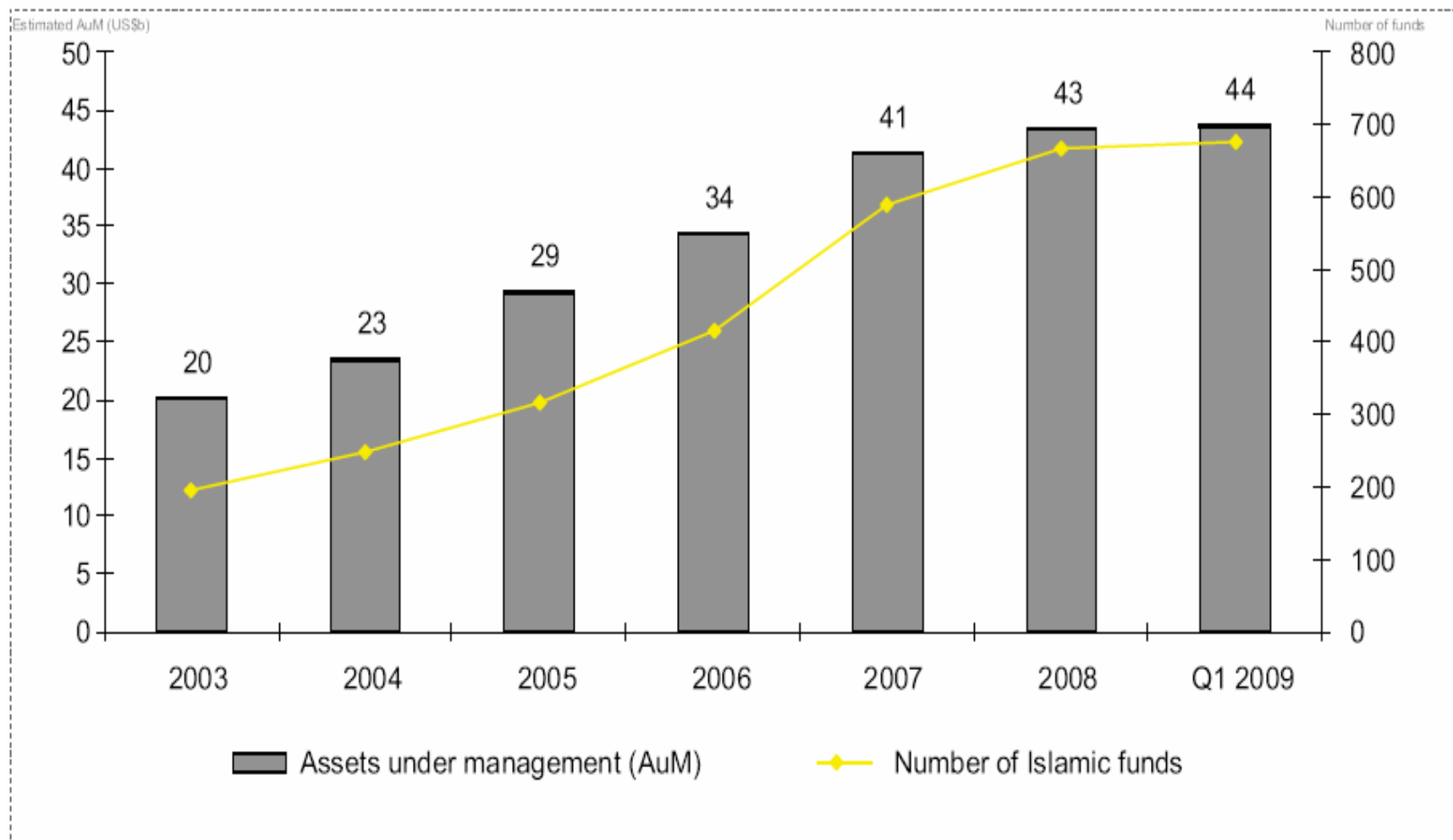
Source: Standard & Poor's, 2009

Shariah-based Unit Trust Funds

Note: * Including feeder funds, fixed income funds, money market funds, structured product and mixed asset funds

Growth*

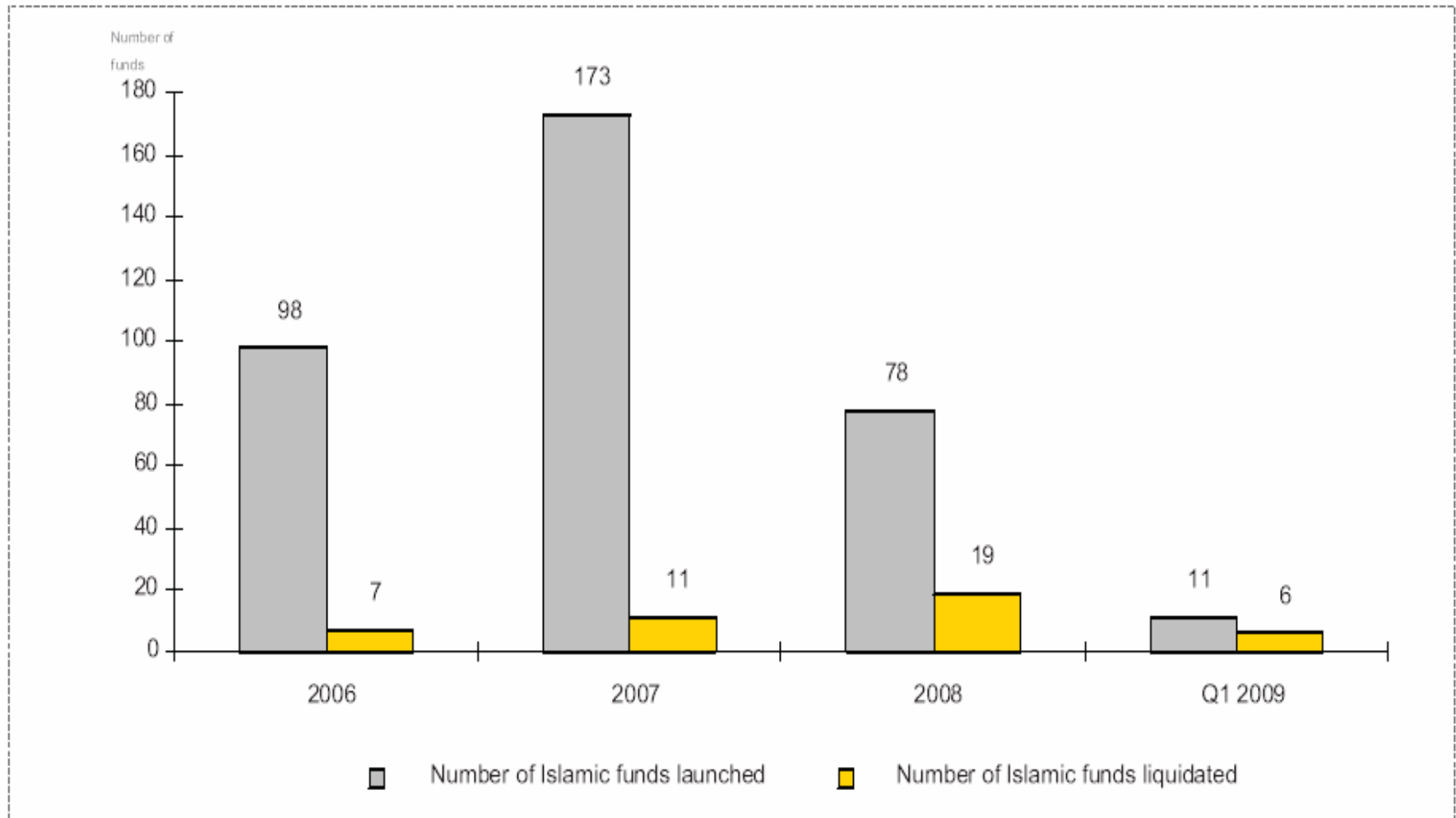
Islamic funds	**41%**
Total funds	**28%**

* NAV growth p.a. 2003-2007

Source: Securities Commission Malaysia, 2007

Global Islamic Funds Industry

Source: Ernst and Young, 2009

Global Islamic Funds
Annual Launches and Liquidations

Source: Ernst and Young, 2009

Direct Islamic Partnership/Investment

- The Contracts: Mudharaba and Musharakah

- Mudharabah => Agreement between capital provider & entrepreneur to enable the entrepreneur to carry out business activities. Profit will be shared on pre-determined ratio and losses will be borne by capital provider
- Musharakah => Partnership financing agreement between two parties or more to enggage in a specific business activity

- Modern Application:Islamic Private Equity Funds & Venture Capital
- Institutions: Gulf Finance House; Kuwait Finance House; Musharaka Venture Management; etc

Opportunities & Challenges

Opportunities

-The growing Muslim awareness
- The growing trend of an ethical investment
- Global Crisis: Prompt the Search for an alternative economic model
- The growing Muslim minority in the West
- Alternative Source of Funding

Challenges

- Transforming the deeply embedded debt intermediation system
- The need to change the broader system
- Innovation & Product Development
- Human Resource Development
- Need "extra efforts" to create understanding to shareholders on the necessity to integrate between "short-term profits objectve" & "longer term bigger objective"

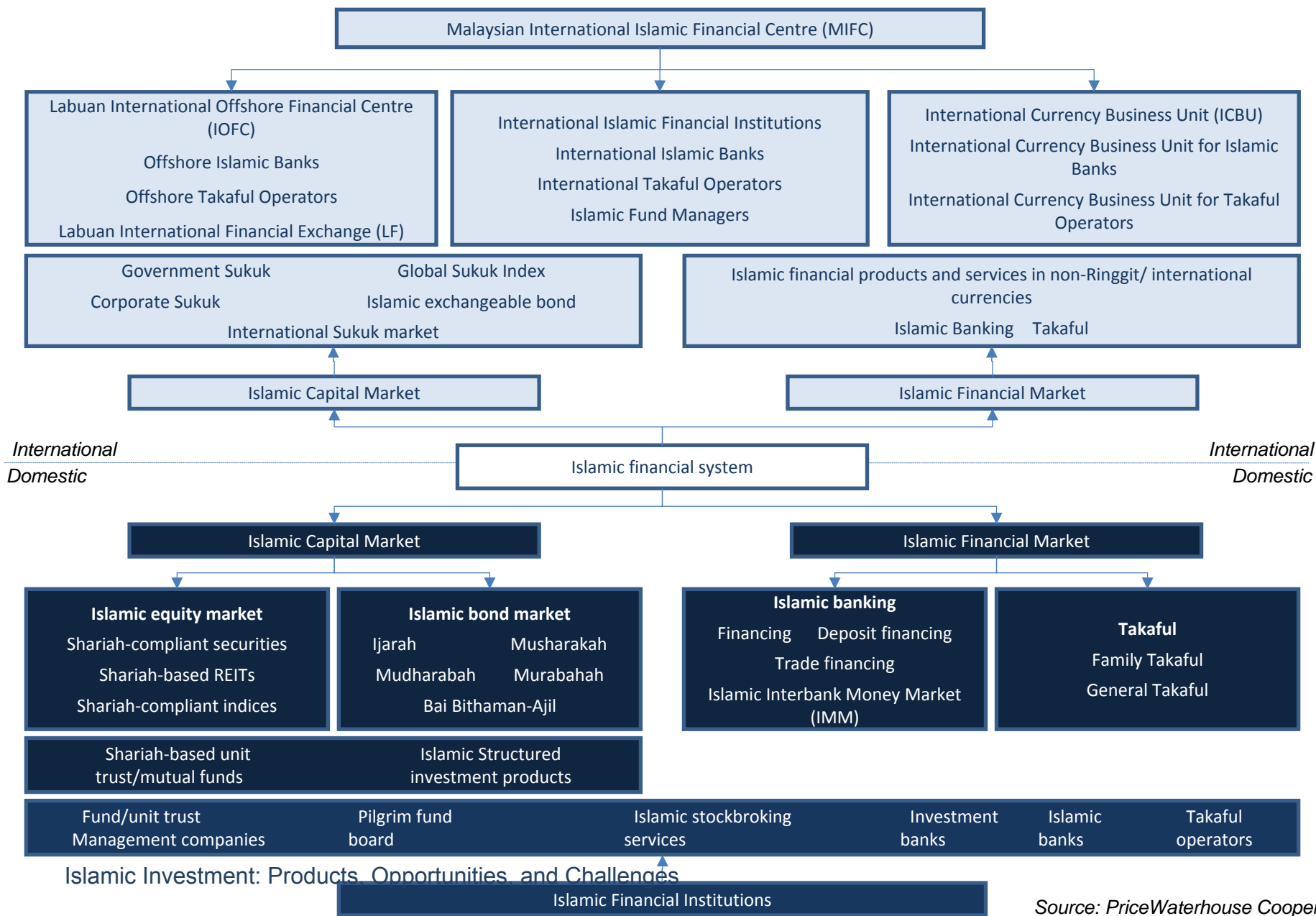
"Efforts however are underway"

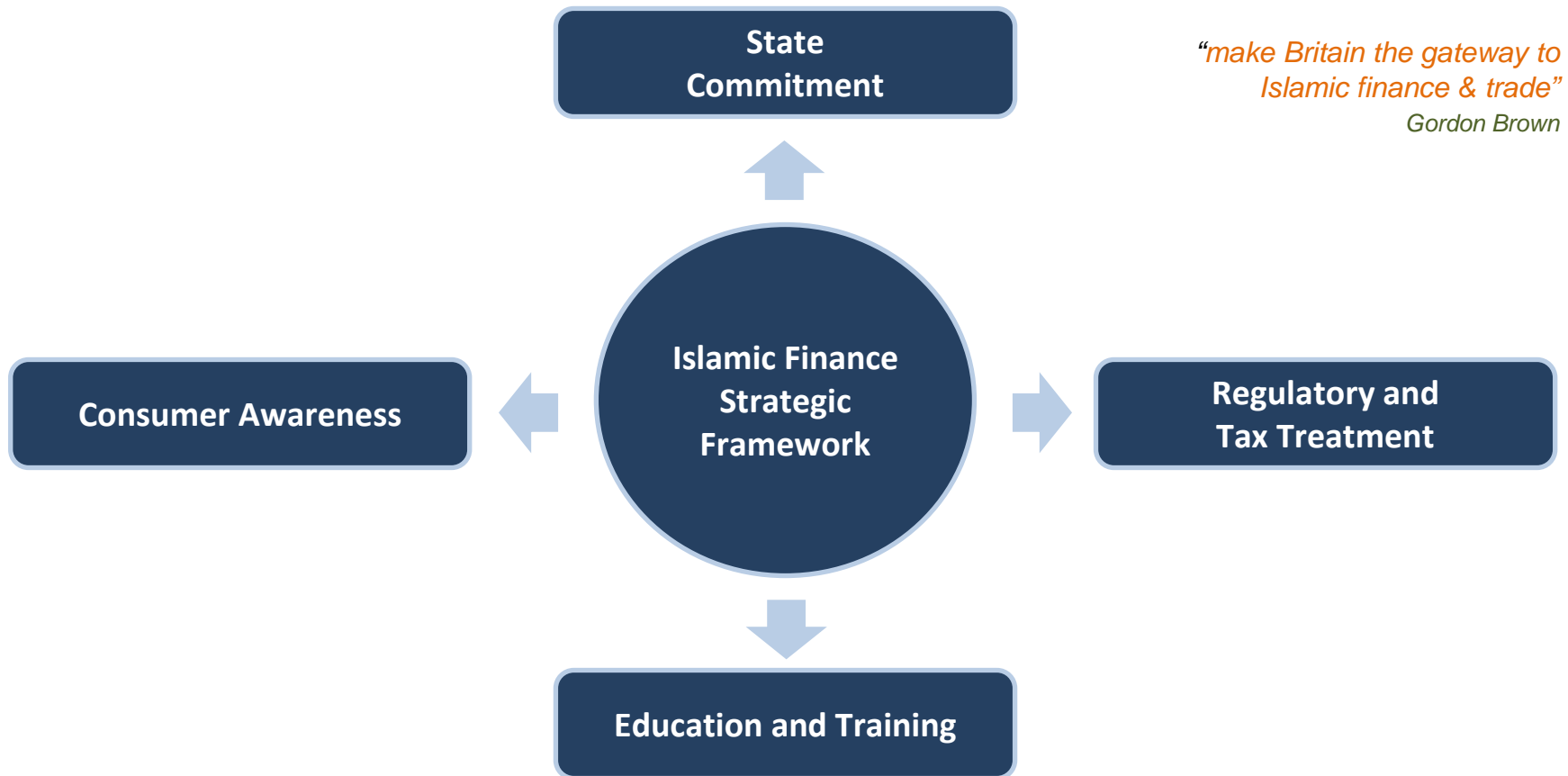
Integrated and Coordinated Approach Taken to Develop Malaysia's International Islamic Finance Position

Source: Bank Negara Malaysia

Malaysia Islamic Finance Industry

Islamic Investment: Products, Opportunities, and Challenges

Source: PriceWaterhouse Coopers

Strategies of the UK in Promoting the Development of Islamic Finance

Source: British Delegation to the 5th WIEF 2009

Islamic Banking ➡ Islamic Investment: Toward Equity Based Intermediation System

- The major cause of the current financial turmoil and most of the previous financial crises is excessive leverage that is inherent consequence of the current debt-based financial system. In contrast, Islam discourages debt in general and in particular incurring debt for living beyond one's means or to grow one's wealth
- Proposed Model:

- Direct risk participation ventures like Mudaraba (Investment Trust);
- Return will be contingent upon the performance;
- The Financial Institution (FI) will not guarantee a fixed rate of return to the investors;
- Mudaraba investment will be treated as off-balance sheet assets and will be 0% risk-weighted for capital adequacy purposes;
- No deposit insurance;
- Savers will not be entitled to any return;
- The banks will not be able to deploy the funds deposited in wadiah accounts, which will have to be 100% risk-weighted;

Source: Haneef, 2009 (WIEF Publication)

Islamic Investment: Toward Equity Based Intermediation System

- The Regulation under the Proposed Model:
  - The wadiah funds are safe and secure;
  - Investors are given adequate information on Mudaraba investments;
  - There are no scams or illegal investments; and
  - The marketing is not misleading, confusing or deceiving;
  - The financial institutions to also co-invest in their portfolios (known as musharaka or partnership financing);
  - The nature of regulation may be a hybrid between the banking regulation and the securities industry regulation.
- More research needs to be done to ensure gradual transition to the alternative model is not disruptive to the economy. Without such a transition, Islamic Finance will never become an alternative and sustainable financial model.

Source: Haneef, 2009 (WIEF Publication)

Proposed Islamic Model & Chicago Plan

- Chicago Plan (proposed during the Great Depression in the 1930s) is a banking reform plan submitted to President Roosevelt by a group of noted economists from the University of Chicago;
- The plan primarily proposed among others the abolition of the fractional reserve model and the separation between commercial & investment banking (i.e. Payment & capital deployment activities). The plan also advocated (i) a 100% reserve for all demand deposits; (ii) a 0% reserve for investment trusts; and (iii) no deposit insurance;
- There is a similarity in term of the abolition of the fractional reserve model between Chicago Plan & the Proposed Islamic Model
- The proposal to abolish the fractional reserve system was dropped due to strong lobbying by bankers, who directly benefited from the status quo model.
- Thus, the saying goes: *"President Roosevelt missed a great opportunity seven decades ago. Let us not miss this opportunity now."*

Source: Haneef, 2009 (WIEF Publication)

The Future of the Islamic Finance Entities: Some Thoughts

- Other than its function to maintain the stability of the real value of money, the *Central Bank* within the Islamic framework should also bear responsibility of foreclosing the possibility of concentration of wealth and power in the hands of vested interests through the financial institutions *(by among others allocation of credit within the framework of socio-economic justice);*
- Commercial banks within an Islamic framework should play the role beyond merely a profit-maximising entity but rather a more goal oriented entity. This entity would be a cross-breed of commercial and investment banks, investment trusts and investment management institutions, and would offer a wide range of services to the customers *(long term bank-client relationship);*
- Specialised credit institutions to assist small & micro businesses through *mudarabah* advances or *qard hasan;*
- Deposit Insurance Corporation (DIC) should be there to insure demand deposits at the commercial banks
- Investment Audit Corporation like DIC should be a government-sponsored organisation whose main objective is to audit the accounts of mudaribs who have obtained funds from others directly or through commercial banks

Source: Chapra, 1986

Critical Success Factors

- **Dedicated people**
  - Greatest intangible to bring the Islamic finance to the new height and build its future
  - Human capital development: financiers and Shariah scholars
- **Synergy between Academic & Business for further development**
  - Academic input to formulate visionary framework and development
  - Capital sponsorship to bring plans to life
- **Change in mindset**
  - From Shariah-compliant to Shariah-driven products and services
- **Education of all key stakeholders**
  - To build understanding and awareness
- **Proactive engagement**
  - Regulators, practitioners and Shariah scholars to set a common agenda

Need for co-ordination to enable further development

Source: Khan, 2007

Closing: In Quest of an Alternative

- "We need more fundamental changes. Economic systems are human creations. Every economic institution and program, from banks and corporations to unemployment insurance and Social Security, is a human invesntion. ... We must decide which economic rules we want to keep and which we want to leave behind, and invent new economic rules taht meet our authentic human needs. If we join together to demand these new rules, we can each play a part in moving toward a more caring economics and a more caring world."

  Riane Eisler

- "According to market fundamentalism, all social activities and human interactions should be looked at as transactional, contract-based relationships and valued in terms of a single common denominator, money. Activities should be regulated, as far as possible, by nothing more intrusive than the invisible hand of profit-maximizing competition. The incursions of market ideology into fields far outside business and economics are having destructive and demoralizing social effects. ... Even if we put aside the bigger moral and ethical questions and concentrate solely on the economic arena, the ideology of market fundamentalism is profoundly and irredeemably flawed. To put the matter simply, market forces, if they are given complete authority even in purely economic and financial arenas, produce chaos and could ultimately lead to the downfall of teh global capitalist system."

  George Soros

- **"Some men see things as they are, and say, 'Why?' I dream of things that never were , and say, 'Why not?'"**

  George Bernard Shaw

Thank you

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